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Kazakhstan Debt Market Assessment

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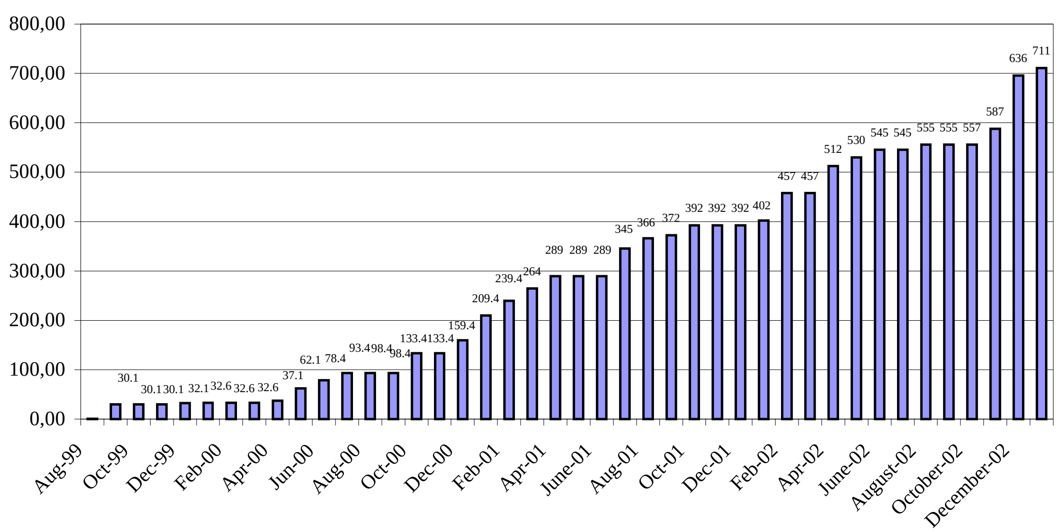
THE EMERGENCE OF DEBT MARKETS IN KAZAKHSTAN

by Stephen S. Moody

Introduction

At the end of January 2003, cumulative corporate bond issuance in Kazakhstan stood at $711 million.[1] This number is significant only when viewed from the perspective that, as recently as August 1999, there were no corporate debt issues in Kazakhstan at all. While some readers might be appalled by the "explosion of debt" in a remote Central Asian republic, others more familiar with economic reform in Russia and other countries of the former Soviet Union might marvel that a market for domestic debt instruments has appeared at all—to say nothing of the fact that each bond has been registered with a national regulatory body, listed on the local exchange and, so far at least, serviced and (those that have matured) redeemed without default.

Cumulative Corporate Bond Issuance, millions USD:
August 1999 - January 2003



The purpose of this paper is to dispel marvel: there's nothing accidental, quirky or bizarre about the emergence of Kazakhstan's debt market. To the contrary, it's the result of the kind of hard, grinding work that occasionally follows compelling visions of the future. That is not to say that there was, from the outset, a master plan for the development of Kazakhstan's debt markets. However compelling, visions of the future don't come with detailed plans. And even if they did, you can build the future only one day at a time. What appears important in Kazakhstan's case is (1) that the vision was thoroughly grounded in the financial realities of Kazakhstan, and (2) that the vision was shared by the National Bank of Kazakhstan and by the United States Agency for International Development (USAID). Domestic political will joined forces with funded foreign expertise to build Kazakhstan's debt market and the institutions intended to sustain it.

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[1] The Pragma Corporation, Kazakhstan Weekly Debt Survey, January 2003.

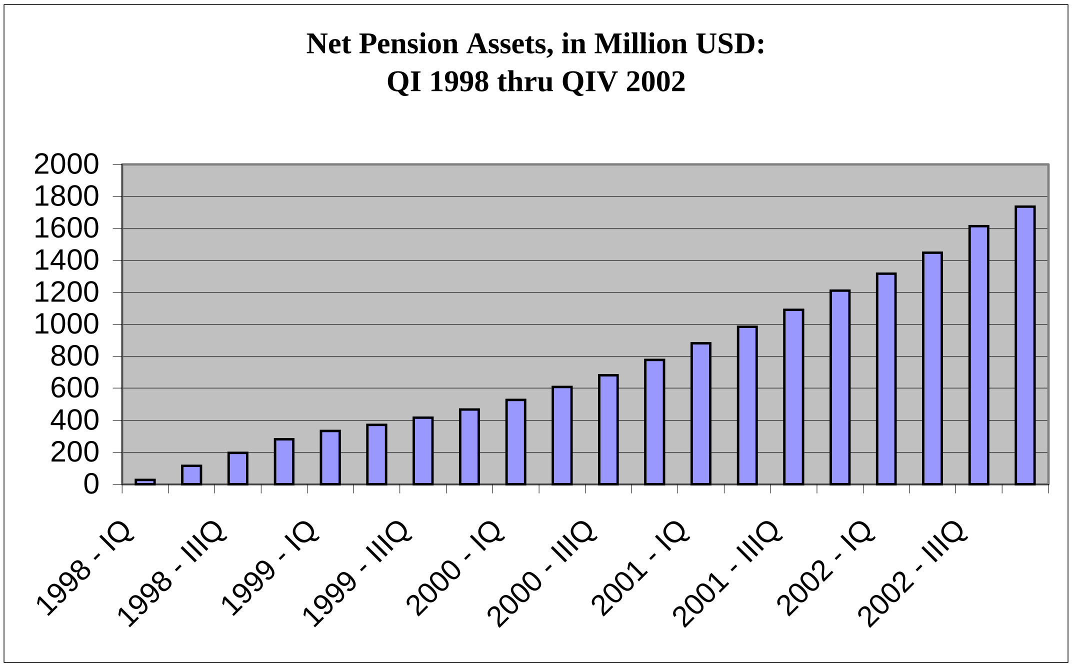
Busting Monopolies

A financial reality that Kazakhstan shares with the entire world is that, while the need for corporate debt arises quite naturally, the demand for debt instruments has to be created. A commercial banking system embodies an appetite for a certain kind of debt instrument, but commercial bank loan agreements are designed to meet lenders' objectives rather than the general demands of corporate borrowers. The mandates and objectives of a commercial bank are to make the greatest possible profit by lending the smallest possible amount of money for the shortest possible length of time to borrowers who present the least possible quotient of risk. While admirable from a bank shareholder's point of view, commercial bank objectives severely curb banks' appetites for debt and, it follows, severely proscribe the stimulative effect financial intermediation should have on an emerging economy. Or, for that matter, a developed one. The complaint that banks lend money only to those who don't need it is not unique to emerging markets. Developed economies are "developed" precisely because they've encouraged other forms and sources of financial intermediation to develop; in developed economies, commercial banks no longer enjoy a monopoly on debt.

The mandates and objectives of private pension funds, insurance companies and investment funds differ, often markedly, from those of commercial banks. Pension funds and insurance companies tend to have longer investment horizons and greater need for risk diversification and, therefore, on the whole, they exhibit a broader appetite for the risks corporate debt entails. From the developmental point of view, however, regardless of the future benefits private pension funds and insurance companies might provide, their greatest benefits to an emerging economy are the initial ones—breaking the commercial banking system's monopoly on debt and lowering the cost of corporate (and eventually personal) borrowing.

Kazakhstan has privatized its pension fund system. More specifically, legislation enabling the creation and operation of private accumulation pension funds and mandating workers' contributions to them was adopted by the Kazakh parliament in 1997. Modeled on the Chilean experience, the Kazakh system that appeared in 1998 consists of a government funded and operated solidarity (or pay-as-you-go) system, a government operated accumulation pension fund (which may be privatized in 2003) and fifteen private pension funds serving some 5.4 million contributors. The government solidarity system will continue to pay pensions prorated to time of service prior to 1998.

Of course, in many economies—emerging and developed—privatizing the pension system means busting a government monopoly. Spendthrift governments like having captive lenders. Understandably, then, the heroic part of economic reform is political will. No amount of foreign expertise—however expert and well funded—can compensate for the lack of political will to challenge commercial banking's monopoly on debt and to privatize pension funds. On the other hand, you can't will a corporate bond into existence.



Net Pension Assets, in Million USD:
QI 1998 thru QIV 2002

Fixed Income Conference

The absence of a credit culture does not necessarily signify a cultural bias against debt and indebtedness. Seventy-odd years of Soviet rule stifled the development of a credit culture throughout the former Soviet Union, but there is no evidence of cultural bias against debt. In Kazakhstan, as everywhere else, there is a whole basketful of commonsensical admonitions against debt ("Neither a borrower nor a lender be . . .") and, once in debt, Kazakhs like everyone else would rather be out of it. And after eight years of rampant devaluation and inflation, the population understandably displays robust distrust of money and banking. But none of this amounts to a cultural bias against debt or credit. Rather, seventy years without consumer—or, for that matter, genuine corporate—lending led to widespread ignorance of the protocols of lending and borrowing and transparency in financial disclosure. Thus arose the need for a little education. The unspoken truth of the old leading-horses-to-water saw is that, unless you lead them to the trough, the horses can't drink whether they want to or not.

In April 1999, a little more than a year after the appearance of Kazakhstan's private pension funds, USAID sponsored a fixed income conference in Almaty. The conference generated enormous interest throughout Kazakhstan, and attendance was greater than expected. Guest speakers from England, the US and Europe addressed a range of issues related to both public and corporate finance, including the principles of fixed income portfolio management. The objective of the conference was to introduce potential corporate issuers to the alternatives to commercial bank loans and acquaint them with the processes and procedures of issuance. And, of course, to demonstrate to pension fund asset managers that corporate bonds could easily be as well underwritten as bank loans.

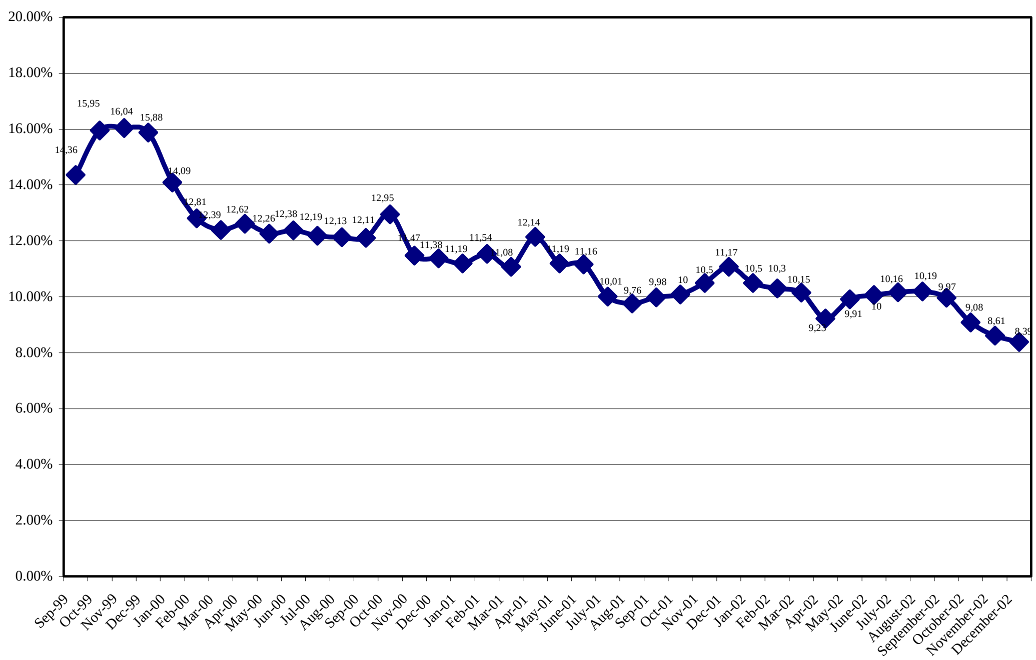
In fact, The Pragma Corporation, USAID's implementing partner in Kazakhstan, had since 1996 been working with the Kazakhstan Stock Exchange (KASE), the National Securities Commission (NSC) and the National Bank (NBK) to develop the legal basis for corporate bond issuance and the prudential norms, regulations and exchange listing requirements that would govern issuers and investors alike. While far from perfect, the law "On the Securities

Market," adopted in 1997, proved an adequate legal platform for the corporate issues that eventually came to market. After the fixed income conference, Pragma's corporate finance consultants began working with potential corporate issuers helping them prepare the *usloviya vypuska* (bond indentures) and investment memoranda required by the NSC and KASE.

Bonds and Banks

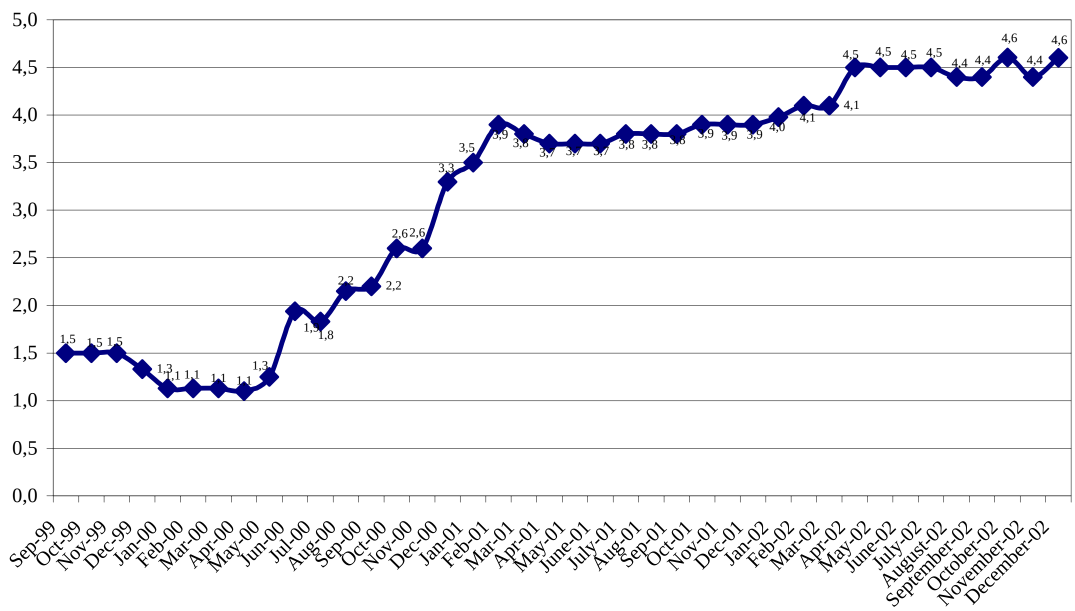
It should come as no surprise that Kazakhstan's early corporate issues were very similar in size, structure and term to commercial bank working capital loans—small amounts, unsecured and short term. And like the interest rates on commercial bank loans, the coupon yields these early bonds carried were initially relatively high although, on average, some eight full percentage points lower than comparable commercial bank loans. In fact, the spread between corporate bond yields and rates on commercial bank loans was so wide that—again no surprise—local commercial banks early on became corporate bond issuers, refinancing their loan portfolios at the domestic investment rate.

Weighted Average Yield To Maturity, in %:
September 1999 - January 2003



Further, all issues—both bank and non-bank corporate—were, and with few exceptions are still today, indexed to the dollar. In fact, an overwhelming percentage (about 70 percent) of all financial transactions in Kazakhstan are still dollar-denominated or dollar-indexed, suggesting that the investment community overcame any aversion to corporate debt well before conquering its fear of devaluation. Dedollarization was not (and probably should not have been) one of the objectives of bond market development. Lowering the cost of corporate borrowing was an objective, of course, as was extending the yield curve. Lower interest rates and longer yield curves are important indicators of economic stabilization. The extent to which introducing a domestic bond market actually contributed to economic stabilization is, unfortunately, impossible to determine, though it stands to reason that it played a significant role: a yield curve is, by definition, better than a yield dot. Issuing bonds, banks in fact refinance at terms longer than those of their deposit base, thereby reducing potential maturity mismatches between assets and liabilities. The longest term bond in Kazakhstan is a seven-year commercial bank issue. Corporate bonds not only lower interest rates, they also make for stronger banks.

Weighted Average Corporate Maturities:
September 1999 - December 2002



Pledge and Bankruptcy

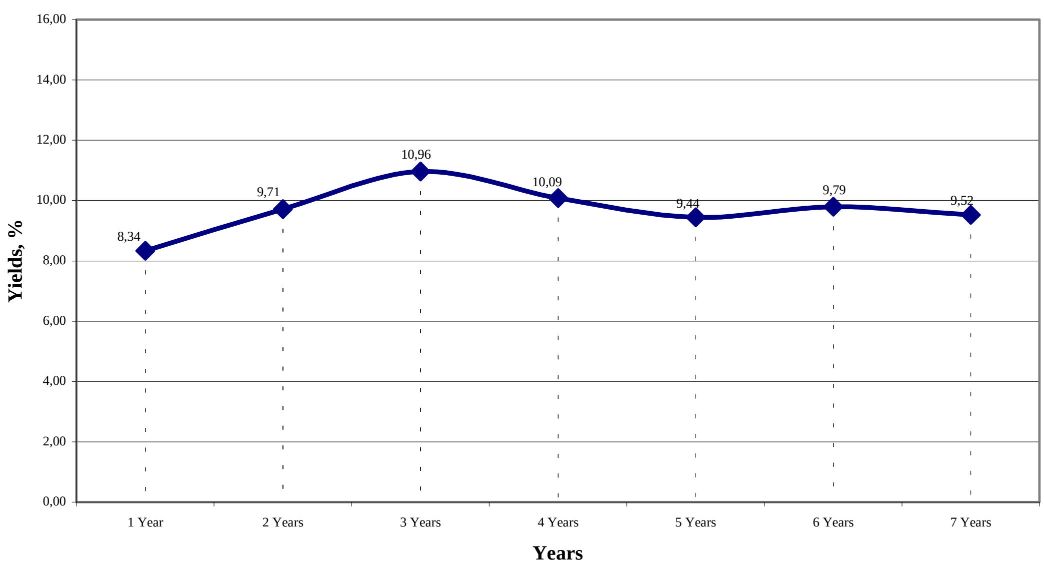
In a little more than three years, dollar-indexed yields on corporate bonds have fallen by almost fifty percent and the average maturity has grown from a little over a year to about four and a half years. And there have been no defaults. Pity. Strange as it might seem, a default would serve the interest of bond market development very nicely. As teaching tools go, default is decidedly pricey; but absent default, it's hard to teach issuers and investors the value of security interest.

Nevertheless, security interest there is. As of January 2003, two issuers had placed some $4.5 million of mortgage-backed securities with pension funds and commercial banks. The issuers were the Kazakhstan Mortgage Company (KMC, a Fannie-Mae-like refinance agency wholly owned by the National Bank) and Lariba Bank, a small commercial bank in Almaty. More accurately termed "mortgage bonds," both issues are secured by mortgage pools, the aggregate outstanding balances of which are 120 percent of the bonds' face values. Both issues feature the additional credit enhancement of a "bondholder representative"—the local version of a trustee; the term "trustee" could not be used because of certain deficiencies in Kazakhstan's trust and pledge laws. The Lariba issue enjoys yet a third credit enhancement: a USAID Developmental Credit Authority (DCA) guarantee on 50 percent of the bond's face value.

Both issues got preferential price treatment from investors. The dollar-indexed Lariba issue was priced to yield 7.99 percent—297 basis points below the trade-weighted average yield for existing unsecured three-year maturities. KMC's inflation-indexed, floating rate issue fared even better—9.99 percent in tenge terms, or about 6.29 percent on a dollar-indexed basis at the time of issue—467 basis points below existing unsecured three-year yields. The spreads imply, of course, that investors do recognize the value of secured interest and credit enhancement; it appears investors generously rewarded—perhaps even over-rewarded—the issuers for collateralization (though mortgage-backed, the issues are not pass-throughs, nor are they securitizations), for trustees and detailed default provisions, for Lariba's DCA guarantee and the other inducements KMC's issue includes.

Unfortunately, the spreads are misleading. In the first place, there are no other truly comparable three-year maturities, secured or otherwise. There are only three-year "tails" on bonds issued earlier when interest rates were generally higher; and trade-weighting can't really compensate for the difference because there's too little trade. There are too few domestic issues to meet the pension funds' fixed income demand. Kazakhstan's is largely a buy-and-hold environment, with the result that Kazakhstan's corporate yield curve fails to accurately capture and convey some fairly basic information—the time-value of money, for example.

Trade Weighted Corporate Yield Curve
(Data as of 6 December 2002)



The weird yield curve and wide spreads mask a more serious problem with security interest in Kazakhstan. Corporate bonds are not only financial instruments; they are also contracts (indentures) between legal entities and, as such, their terms and conditions must comport with the law of the land. On the matter of security interest (i.e., pledge), Kazakhstan's Civil Code contradicts itself. The statutes on pledge grant security interest; the statutes on bankruptcy take it away. As written, Kazakhstan's law does not currently support security interest. Houston, we have a problem.

The crux of the matter is this: under Kazakh law, pledge does not survive bankruptcy unimpaired. The law neither excludes pledge from bankruptcy estate nor grants pledge holders priority over all other creditor classes in the settlement of bankruptcy estate. In bankruptcy of a non-bank legal entity, pledge holders' claims are met in third order of priority; in bankruptcy of a bank, sixth order. From the creditor's point of view, pledge must be able to survive unimpaired all possible financial and legal events, including bankruptcy of the borrower, for the lifetime of loan; an impaired pledge is, in fact, no pledge at all. And anyone or anything that comes between the pledge and the pledge holder *to any degree at any time for any reason* during the term of the loan is impairment.

At a pledge party, there's no room for the uninvited—including governments of developing economies, which often at this critical juncture in bankruptcy law mistakenly insert some fuzzy-wuzzy feel-good factor purportedly for the protection of the "little guy"—widows and orphans, veterans of foreign or nearly forgotten wars, the weary, the downtrodden or the merely out-of-luck. All societies need programs that succor the disadvantaged and the weak and protect ordinary citizens from the random ravages of everyday life. But social programs should not be embedded in bankruptcy law, and their benefits should not impair pledge. Social programs that impair pledge protect no one.

The penalty for impairing pledge is lack of economic growth. The laws of virtually all developed countries either exclude pledge from bankruptcy estate or, as in the United States, give pledge holders priority over other creditor classes. What the lawgivers of developed countries know, and the lawgivers of developing countries do not (or pretend not to) understand, is that pledge is the cornerstone of secured lending, and secured lending is the unshakable foundation on which widespread, robust financial intermediation is built. Finance, as they say, is the handmaiden of industry: it is *the* engine of economic growth. And nothing—absolutely nothing—is of greater benefit to the seething masses of little guys all around the world than thriving economies. A rising tide lifts all boats, and the tide tends to rise faster and higher in economies with pledge. Sadly, in economies without it, tides rarely rise at all.

Conclusion

A legal working group chaired by the National Bank has drafted amendments and additions to Kazakh law, which redress deficiencies in numerous statutes, including those governing the treatment of pledge holder claims in bankruptcy proceedings. The draft amendments and additions are presently in committees in preparation for Parliament's first reading in the spring of 2003. With the pledge issue, Parliament has the opportunity to either add a chapter to or end the story of the emergence of debt markets in Kazakhstan. Again the story turns on the heroism of political will. Or the lack of it.

To paraphrase Lenin, all economics is local. That may be true, but it's also true that economic events—however localized—occur in a broader context. Kazakhstan's broader context is post-Soviet economic reform. Technically speaking, building a corporate bond market from scratch is not economic reform; it's economic development. In practice, of course, it's hard to tell where reform ends and development begins. And it may not make any difference. Economic reform and development on the scale occasioned by the collapse of the Soviet Union may never occur again. If it does, however, reformers would do well to keep in mind that de-monopolizing and privatizing debt is easily as important as privatizing bricks and mortar. Bricks and mortar can't work without credit. That's the vision the National Bank of Kazakhstan and USAID shared.